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No.

In The Supreme Court

Of The

United States

OCTOBER TERM, 1982

ESTATE OF ERNEST D. SKAGGS, DECEASED,
CAROLYN C. FIKE, EXECUTRIX, AND
CAROLYN C. FIKE, FORMERLY CAROLYN C. SKAGGS
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For
A Writ of Certiorari To The
United States Court Of Appeals For
The Ninth Circuit

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QUESTION PRESENTED FOR REVIEW

Whether a partnership, composed solely of a husband and wife who held their partnership interests as community property, is for federal income tax purposes deemed to exist upon the death of one spouse.

TABLE OF CONTENTS

Question Presented for Review i

Table of Contents ii

Table of Authorities iii

Opinions Below iv

Jurisdiction iv

Statement of the Case 1

Reasons for Granting the Writ

A. The Nature of the Reasons 5

B. The Partnership Ceased to Exist Following the Death of Ernest 5

C. The Decisions of the Tax Court and the Court of Appeal are in Conflict with Decisions of this Court 8

D. The Issue Presented Constitutes an Important Question of Federal Tax Law Which Has Not Been, But Should Be, Addressed by This Court .. 9

Conclusion 12

TABLE OF AUTHORITIES CITED

Cases: Page

Colden v. Costello, 50 Cal. App. 2d. 363, 122 P. 959 (Ct. App. 1942) 7
Morgan v. Commissioner, 309 U.S. 78, 60 S. Ct. 424 (1940) 8

Statutes:

Arizona Revised Statutes Sec. 25-214 9
California Civil Code (West 1970) Sec. 5125 9
California Corporations Code (West 1977) Sec. 15006 5
Idaho Code Sec. 32-912 9
Nevada Revised Satutes Sec.123.230 9
New Mexico Statutes Annotated Sec. 57-4A-8 9
Texas Family Code Annotated (Vernon) Sec. 5.22 9
Washington Revised Code Annotated Sec. 26.16.030 9

Internal Revenue Code of 1954 (26 U.S.C.):
Sec. 708 8
Sec. 754 3,9,10
Sec. 1014 3,4
Sec. 7442 4
Sec. 6213 4

Miscellaneous:

Treasury Regulations on Income Tax (26 C.F.R.):
Sec. 1.708-1(b) 6
Sec. 301.7701-1(c) 9

OPINIONS BELOW

The Opinion of the Court of Appeals is reproduced in the Appendix, page A-1. The Order Amending Opinion And Denying Rehearing is reproduced in the Appendix, page A-5. The opinion of the United States Tax Court is reported at 75 T.C. 191 (1980) and is reproduced in the Appendix, page A-7.

JURISDICTION

The Opinion of the Court of Appeals was filed on March 24, 1982. The Order Amending Opinion And Denying Rehearing of the Court of Appeals in response to Petitioners' Petition for Rehearing, was filed on May 27, 1982. The jurisdiction of this court is invoked under 28 U.S.C. §1254(1).

STATUTES AND REGULATIONS INVOLVED

The full text of the statutes and the pertinent provisions of the regulations involved in this case, identified by the following citations, are set forth in the Appendix, at page A-33, et seq.:

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 708

Sec. 754

Sec. 743

Treasury Regulations on Income Taxes (26 C.F.R.)

Sec. 1.708-1(a) to 1.708-1(b) (1) (i) (a)

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STATEMENT OF THE CASE

Ernest D. Skaggs ("Ernest") and Carolyn C. Skaggs (now Carolyn C. Fike, hereafter "Carolyn") were husband and wife. They were domiciled in California and operated a farm (the "Santa Rita Ranch") near Los Banos, California. California

community property law as it then existed gave sole management and control of community property to the husband (Cal. Civil Code §5125, repealed January 1, 1975). Desiring to give Carolyn equal participation in the management and control of Santa Rita Ranch, the spouses on April 22, 1967 executed a written partnership agreement which made Carolyn and Ernest sole and equal partners in Santa Rita Ranch. Ernest died on December 31, 1973, leaving Carolyn, his widow, as sole remaining partner. Ernest's Will named Carolyn as sole beneficiary and nominated her as Executrix.

When Ernest's Will was admitted to probate, Carolyn was appointed and qualified as Executrix. Under the law of California in effect at that time, all of the community property owned by a husband and his widow at the date of the husband's death became subject to probate administration.

Article 8 of the Santa Rita Ranch partnership agreement provided that "the partnership shall terminate upon the death of either partner". On February 28, 1974, Carolyn as Executrix filed with the Probate Court a petition verified by her oath which set forth that the Santa Rita Ranch partnership terminated upon Ernest's death and that, as a result of such termination, the assets of the farming business theretofore conducted by the partnership became subject to the jurisdiction of the Probate Court.

On March 15, 1974, the Probate Court made its "Order Authorizing Executrix to Continue Operation of Farming Business". The Order found that the partnership terminated upon Ernest's death and that all of the partnership assets became subject to the jurisdiction of the Court. Said Order

authorized Carolyn as Executrix to continue the operation of Santa Rita Ranch under the same name as had been used by the partnership.

For the calendar year 1974, Carolyn C. Skaggs filed two federal income tax returns. One was a fiduciary return (Form 1041) for the Estate of Ernest D. Skaggs. The other was an individual tax return (Form 1040) for herself. Each item of 1974 income and expense from Santa Rita Ranch was apportioned in said returns one-half to the Estate and one-half to Carolyn. In both the fiduciary and the individual returns, Carolyn claimed as a deduction for "basis in growing crops", the amount of $207,968, or one-half the fair market value of unharvested crops on hand as of the date of Ernest's death. Similar recomputations were made of the basis of the other assets of Santa Rita Ranch, on the theory that under Section 1014 of the *Internal Revenue Code* (the "Code") it was proper to "step up" the basis of each such asset to its value at the date of Ernest's death.

Ernest had died on the last day of the partnership's 1973 taxable year. The partnership filed a 1973 tax return but filed no subsequent returns. It made no election pursuant to *Code Section* 754.

The Commissioner of Internal Revenue determined that the partnership continued in existence following Ernest's death and therefore, because no such election was filed by the partnership, the new date-of-death basis under Section 1014 applied only to the partners' partnership interests in Santa Rita Ranch and not to the assets held by Santa Rita Ranch. He therefore disallowed the basis "step up" and imposed tax assessments totalling $252,344.00 on Carolyn and the Estate.

This case was originally tried in the United States Tax Court. Jurisdiction before the Tax Court was established under *Code Sections* 7442 and 6213(a).

The case was submitted for decision to the Tax Court on a detailed and comprehensive stipulation of facts. It is devoid of anything explicity acknowledging the existence of a partnership. For example, the documents filed in the probate proceedings and made a part of the Tax Court record contain nothing stating that Carolyn, as Executrix, took into her possession a partnership interest, had receipts from or made disbursements to any partnership, or sought an authorization to join with any other partner in the operation of Santa Rita Ranch. Even the form of the statutory notices of deficiency issued by the Commissioner of Internal Revenue are consistent with the termination of the partnership as of the date of Ernest's death. The notices adjust the basis of the "partners" under *Code Section* 1014 rather than adjusting taxable income from the partnership. An adjustment to the basis of partnership assets (not individual assets), thereby increasing partnership taxable income, would have been the only appropriate adjustment under the Commissioner's theory.

The Tax Court nevertheless sustained the position of the Commissioner.

The United States Court of Appeals for the Ninth Circuit affirmed the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

A. The Nature of the Reasons.

This is a case of first impression. Research has disclosed no case involving either tax law or local partnership law that comes close to presenting the specific factual and legal relationships that are involved in this case.

The holdings of the Court of Appeals and the Tax Court impose a tax result which contravenes the property rights and interests of Carolyn, both as Executrix and individually, under California partnership, probate and community property laws. For this reason, the decision of the Ninth Circuit conflicts with decisions of this Court with regard to the significance of state law in determining the property rights of taxpayers. The decision affects not only the rights of taxpayers in the State of California, but also the rights of taxpayers in other community property states. It creates a serious and unnecessary trap for taxpayers in such states. The issue presented therefore constitutes an important question of federal tax law, which has not been, but should be, addressed by this Court.

B. The Partnership Ceased to Exist Following the Death of Ernest.

Section 15006 of the *California Corporations Code* defines a partnership as follows:

> "A partnership is an association of two or more persons to carry on as co-owners a business for profit."

The two essential elements of a partnership, then, are the existence of two or more persons and an agreement to act

together in such a way as to become a partnership.

By the terms of the Santa Rita Ranch partnership agreement and the orders of the California Probate Court, the partnership ceased to exist upon Ernest's death and all interest in all of the assets in Santa Rita Ranch merged into Carolyn as Executrix. After the merger, there was no longer an "association" of two or more persons in existence who held an interest in Santa Rita Ranch to act as a partnership after Ernest's death. The conclusion of the Tax Court that the partnership continued after Ernest's death is therefore contrary to California law.

The Tax Court based its holding that the partnership continued to exist on *Treasury Regulation* Section 1.708-1 (b). This Regulation provides that the death of a partner does not terminate a partnership if the estate of the deceased partner continues to share in the profits and losses of the business. This rule makes sense in a non-community property state. In a common law jurisdiction, the decedent's estate is simply "slipped into the shoes" of the decedent's and the business is continued in partnership with some other party. By creating a continuity for tax purposes, the Regulation prevents an artificial termination of the partnership with the simultaneous commencement of what is essentially the same partnership with the estate of the decedent in place of the decedent.

But the Tax Court's application of the cited Regulation to the facts of the case at bar is inappropriate because only one person - Carolyn, as Executrix - existed who had the legal right to the possession and use of the partnership assets under California partnership, probate and community property laws.

Under the California probate law in effect at Ernest's death, the probate of his estate was an action *in rem* binding on all creditors and claimants, including his widow, under the plenary supervision and control of his legal representative and the Probate Court. *Colden v. Costello*, 50 Cal. App. 2d 363, 370, 122 P. 959 (1942). As Executrix, Carolyn had complete power to carry on the farming business operations. Carolyn's sole right and power, as Executrix, over the assets of the business negates the possibility of the existence of two persons to consent to the formation or continuation of a partnership for tax purposes. The decision of the Tax Court thus fails to recognize the rights and interests of Carolyn, as Executrix, as established under the probate laws of the State of California.

The Tax Court reasoned, however, that because there were two *taxpayers*, Carolyn individually and Carolyn as Executrix, to report the income from the business, there were two *persons* in existence to continue the partnership. The income taxation of the income of Ernest's estate would have been the same if Ernest had operated the farming business as a sole proprietorship composed of community property and his estate had succeeded to it: the two taxpayers are recognized regardless of the existence of a partnership. Their recognition as such therefore cannot be evidence of the existence of a partnership. The fact that two taxpayers were required by the federal tax laws to report the income from the business does not necessitate the conclusion that said two taxpayers each had ownership interests in the assets of the business sufficient to enable them to constitute a partnership.

The Tax Court further reasoned that although the partnership dissolved on Ernest's demise, it did not terminate

until its affairs had been wound up. In so holding, the Tax Court confused the notion of winding up a *business* with the concept of winding up a *partnership*. The Tax Court determined that because the business was not wound up and terminated until several months following the date of death of Ernest the partnership necessarily was not wound up and terminated until that time. The Court failed to recognize that, under California law, a partnership may distribute its assets at any time, regardless of the condition of its business. The fact that the partnership terminated and all of the assets of the partnership were distributed to Carolyn, as Executrix, as of the date of death for purposes of State law is amply evidenced by the holding of the Probate Court.

Code Section 708 states that a partnership shall be considered as terminated if no part of any business continues to be carried on by any of its partners *in a partnership*. Clearly, if the partnership distributes out all of its assets it has terminated. The fact that Carolyn, as Executrix, continued to hold the assets and wind down the business does not mean that a partnership continued to exist.

C. The Decisions of the Tax Court and the Court of Appeal are in Conflict with Decisions of this Court.

This Court in *Morgan v. Commissioner*, 309 U.S. 78, 60 S. Ct. 424 (1940), laid down the rule that State law establishes the right of taxpayers and federal tax rules designate how those taxpayers shall be taxed given the nature of those rights.

> State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Id. at 80, 60 S. Ct. at 426.

See also, Treasury Regulation 301.7701-1(c).

Under California State law, only one person - Carolyn, as Executrix - held all of the rights, interest and powers in the assets of Santa Rita Ranch and the partnership ceased to exist as of Ernest's death. Under *Code Section* 754, only a partnership may make the Section 754 election. Under California probate, partnership and community property laws, no partnership existed after Ernest's death. Thus, no Section 754 election was possible or required.

D. The Issue Presented Constitues an Important Question of Federal Tax Law Which Has Not Been, But Should Be, Addressed by This Court.

Under the community property laws of the State of California prior to 1975, Carolyn had no right to manage Santa Rita Ranch. Therefore, she and Ernest executed a partnership agreement giving her that power. The law was later changed and now both spouses have equal right to manage the community property. *Cal. Civil Code Sec.* 5125. Equal right of management now prevails in most community property states. *Ariz. Rev. Stat.* §25-214, *Idaho Code* §32-912, *Nev. Rev. Stat.* §123.230, *N.M. Stat. Ann.* §57-4A-8, *Tex. Fam. Code Ann.*§5.22 (Vernon) and *Wash. Rev. Code Ann.*§26.16.030. Consequently the adverse effect of the decisions of the Tax Court and Court of Appeals will impact on every husband and wife business not only in the State of California, but in every other community property state.

The holdings of the Tax Court and the Court of Appeals, by confusing the rights and interests of the two spouses in their community property, create a serious and unnecessary trap for taxpayers in community property states. The Court of Appeals, in its Order Amending Opinion and Denying Rehearing, stated that its review was limited to facts where a husband and wife executed a formal partnership agreement and does not deal with, nor apply to, an "ordinary community property situation...." Yet the facts involved are indistinguishable from an ordinary community property situation. Community property ownership of a business engenders both spouses with an equal right to possession and management. The management of a community property business by spouses is, because of the nature of community property, essentially a partnership.

As indicated above, federal tax laws determine whether a partnership exists for tax purposes once the rights and relationships of the taxpayers have been determined by local law. Because every community property proprietorship business is essentially a partnership, the Commissioner of Internal Revenue could in each case require every surviving spouse of a community property business to file a partnership return containing an election under *Code Section* 754 in order to obtain a stepped up basis for the business assets where the spouses never contemplated a partnership business or filed a partnership return prior to the date of death of the deceased spouse.

The distinction which the Court of Appeals makes between the existence and nonexistence of a written partnership agreement creates a distinction between the business operations of various groups of spouses where no difference in

rights and powers exists. The decision adversely affects every husband and wife business operated in a community property state. All such taxpayers run the risk of losing a stepped up basis on the death of either spouse. The footnote added by the Court of Appeals does not address or provide an answer to the serious risks which arise in the "ordinary community property situation" under this decision. The addition of the footnote merely highlights the existence of the problem rather than resolving it. If the problem did not exist, why did the Court of Appeals add the footnote?

The decision below thus imposes a tax result upon the taxpayers which is in conflict with the rights of the taxpayers as established under the partnership, probate and community property laws of the State of California and which generates an arbitrary distinction between various groups of taxpayers. The decision will have an adverse effect on taxpayers of all community property states and is contrary to previous decisions of this Court with respect to the significance of local law in determining the property rights and relationships of taxpayers for tax purposes.

CONCLUSION

For the foregoing reasons, the Petition for Certiorari should be granted.

Respectfully submitted,

THOMAS, SNELL, JAMISON, RUSSELL, WILLIAMSON & ASPERGER

By William N. Snell

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